

IMPROVING GLOBAL FINANCIAL STABILITY

EXECUTIVE SUMMARY

International capital markets have expanded rapidly in the past decade due to major advances in technology, reforms of economic and political institutions in developing countries, and rapid growth in trade and investment. The continuing globalization of financial markets holds the promise of higher incomes and improved social conditions for open economies. However, the costs of recent financial crises have been significant. Unless greater stability in the international financial system is achieved, the promise of economic and social development may go unfulfilled.

CED's recommendations focus on actions that can be taken by developing countries and the International Monetary Fund (IMF) to prevent financial crises and restore stability when they occur.

FINDINGS

- The international financial system is fundamentally sound, although more susceptible to financial crisis than it need be.
- Problems in crisis countries for the most part have been home grown. Countries with inadequate social and legal infrastructures, weak banking systems, and



poor government policies are susceptible to financial crises and capital flight.

- While reforms are necessary, some proposed reforms would do more harm than good. Rules to impose additional costs on private-sector lenders and investors, such as mandated “bail-ins” or collective action clauses in bond contracts, would undermine the fundamental goal of transferring capital to developing countries.
- No matter how good preventive efforts are, financial crises are likely to occur. When they do, a strong international backstop—the International Monetary Fund—is needed to restore confidence and stabilize the system.

RECOMMENDATIONS

Developing country governments, to participate in the global financial system at maximum benefit and minimum risk, should upgrade their institutions and policies to support market-based economies open to international investment.

Specifically, they should:

- increase the transparency and accountability of both government and private institutions;
- strengthen procedures in accounting, banking regulation, bankruptcy, and corporate governance

Committee for Economic Development

477 Madison Avenue, New York, New York 10022

Phone: 212-688-2063 Fax: 212-758-9068

2000 L Street, NW, Suite 700, Washington, DC 20036

Phone: 202-296-5860 Fax: 202-223-0776

Web Site: www.ced.org



and subscribe to international codes of conduct based on standards and best practices in these areas;

- establish comprehensive social safety nets to protect and assist vulnerable groups in times of crisis and recovery;
- move (in most cases) towards flexible exchange rates, which provide open economies with speedy and efficient adjustment to changing economic conditions;
- build sufficient international reserves to weather crises and establish private lines of credit that can be called upon in emergencies;
- consider using temporary taxes on short-term capital inflows while strengthening their financial systems to allow full participation in open capital markets.

The International Monetary Fund is essential to help countries prevent crises and to provide or restore stability when they occur. It is important that the IMF have adequate — though not abundant — resources to perform both these functions effectively.

Crisis Prevention

- The IMF should place more emphasis on crisis prevention and less on costly stabilization programs.
- The IMF must continue to become more transparent and accountable to its members and the international public with regard to its decision-making and activities.
- Public access to information is essential to crisis prevention. The IMF should *require* the public release of information developed in the course of Article IV consultations, rather than merely encourage such release as it does currently.

- The IMF must take greater responsibility for identifying, monitoring, and investigating the use of its funds and must ensure that such funds are not siphoned off in fraud and corruption. Where fraud and corruption preclude the sound functioning of political, legal, and judicial systems, the IMF should withdraw its support.
- The IMF and developed country governments should recognize that the world's poorest countries lack both the resources and incentives to improve domestic policies while burdened by debt they cannot repay. Relieving official debt and providing other financial and technical assistance to very poor countries will help prevent future crises.

Crisis Resolution

- The IMF should observe its normal lending limits and operate under a policy of “constructive ambiguity” with regard to specific cases and concerns about moral hazard. Its first priority, however, must be to maintain or restore confidence to stem a crisis.
- The IMF should act as a neutral “crisis manager” when crises do occur. Its proper role is neither to “bail in” nor “bail out” foreign lenders.

CONCLUSION

The international financial system will be strengthened as developing countries bring their economic practices and domestic institutions up to world-class standards and rely more on the power of markets to facilitate economic growth and development. CED's recommendations reflect our conviction, founded on our direct experience, that markets will reward countries with sound institutions and good economic policies.

However, we recognize that financial crises will inevitably occur. We believe the IMF will be indispensable in preventing such crises where possible and stabilizing afflicted economies when prevention fails.

We urge business leaders and officials in governments and the IMF to carry out the comprehensive set of incremental reforms recommended in this report. These reforms must be viewed as a package, since many individual recommendations will be effective only if others are implemented.